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Sept. 10, 2020

Mia Sowell, Acting Program Manager
Small Dollar Loan Program, CDFI Fund
Submitted via email to cdfihelp@cdfi.treas.gov

Dear Ms. Sowell:

We write in response to the request for information on the Small Dollar Loan Program administered by the CDFI Fund. The Pew Charitable Trusts is a global, non-governmental research and public policy organization dedicated to serving the public. We strive to improve public policy by conducting rigorous analysis, linking diverse interests to pursue common cause, and focusing on tangible results. As explained below, consumer finance is an area to which Pew has dedicated significant resources in recent years.

We commend you for this effort to make affordable, CDFI-issued, small installment loans available to the millions of American families who could benefit from them. Unfortunately, even though many CDFIs offer small-loan programs, few have achieved sufficient scale to become true alternatives to payday and other high-cost loans. As explained below, this is largely due to uncompetitive pricing strategies and especially to slow or inefficient loan origination practices that raise operating costs and reduce the competitive appeal of the loans to consumers. With proper assistance from specialty providers skilled in automated underwriting and origination, CDFIs can compete successfully in the market and leverage the inherent advantages of diversified mainstream financial institutions to offer affordable payments and substantially lower prices than payday and other high-cost lenders. **Therefore, we recommend that the CDFI Fund give priority to programs that demonstrate long-term financial sustainability and have a path to scale—and that the bulk of funding, if not all funding, go to technical assistance for automating small-dollar lending rather than to loan-loss reserves.**

Pew's qualifications for submitting these comments

Pew began work on small-dollar loans in December of 2010, five months after Congress authorized the creation of the CFPB as part of the Dodd-Frank Act. Pew's consumer finance project works to provide thorough, objective analysis to help inform the efforts of policymakers. We have worked to fill gaps in available research about the markets for payday, auto title, and similar forms of small-dollar loans, particularly with respect to understanding the needs and experiences of borrowers and identifying and evaluating policy responses to perceived consumer harms. Now, more than nine years later, Pew's consumer finance project has produced a comprehensive body of research and developed a group of highly qualified experts on this subject.

In July of 2012, we published our first report, entitled "Payday Lending in America: Who Borrows, Where They Borrow, and Why." This report included findings from a first-ever nationally representative telephone poll of payday loan borrowers about their experiences using the loans.[1] The *Payday Lending in America* series of reports grew over the following years to include a total of five reports about storefront payday lending, online payday lending, and auto title lending.[2] As of this writing, Pew's research and contributions to the literature include the following:

- Unique, nationally representative surveys consisting of in-depth telephone interviews with borrowers of payday and similar loans (as well as the general public) conducted according to the highest standards of survey research.

- Conversations with hundreds of borrowers in more than 20 focus groups throughout the country.

- Scores of meetings, interviews, and store visits with nonbank lenders and consumer finance professionals across many industries.

- More than 100 conversations with bank and credit union officials about small-dollar lending. We convened a group of executives from more than ten banks (which collectively operate approximately one-fifth of all bank branches in the United States) to discuss federal regulation of small-dollar loans.

- Standards for bank and credit union small-dollar loans based on our research with consumers and executives from banks and credit unions.

- Development of safer payday and auto title installment loan models that are viable for lenders and result in far better outcomes for consumers.

- Extensive consultation with community groups throughout the country, including representatives of consumer advocacy groups, civil rights and faith-based organizations, consumer credit counselors, legal advocates, and others.

[1] The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf.
[2] The reports are available as a collection online at http://www.pewtrusts.org/en/research-and-analysis/collections/2014/12/payday-lending-in-america.

- Analysis of academic literature and regulatory data. We have read all published academic papers about payday and auto title loans and reviewed all publicly available data about this market from state and federal government agencies as well as additional non-publicly available data obtained through special requests to various regulators and private companies.

- Including the five *Payday Lending in America* reports, Pew's consumer finance project has released more than two dozen carefully researched and reviewed issue briefs, fact sheets, and multi-media publications, available at www.pewtrusts.org/small-loans.

- In recent years, we have provided comment letters, testimony, technical assistance, and informal input to federal regulators and state government officials throughout the country and spoken about this topic at dozens of conferences and other professional gatherings. Our work has been cited or quoted in a wide variety of publications from federal, state, and local government officials.

- Pew's publications on small-dollar loans have been cited in scholarly articles by academics and other researchers more than 150 times.

- Pew's work on small-dollar loans has been cited in more than 1,000 media stories.

Pew spent nearly three years researching the markets for payday and similar forms of small-dollar credit before developing initial policy recommendations in October 2013.[3] The report included a case study of Colorado's 2010 payday loan reform law (which converted payday loans in that state from conventional short-term loans to those with six-month terms); survey data finding that borrowers favor having more time to repay loans in smaller installment payments; and discussion of various potential benefits and harms associated with installment lending and how policy could help ensure that the migration to installment lending is safe and effective.[4] In the years since, we have revisited the data underlying that report and supplemented our recommendations with additional research and analysis, making revisions where appropriate.

Pew is deeply committed to unbiased research and dedicated to improving public policy through pragmatic measures that would accommodate legitimate interests of both borrowers and lenders, as well as the public generally. Stakeholder outreach has been a constant feature of our work since it started.

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[3] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf.
[4] Id.

In sum, Pew is highly qualified to respond to the CDFI Fund's Request for Information. We hope the CDFI Fund finds value in our input and are glad to discuss our recommendations further.

Expanding Access to Affordable Small Installment Loans

Thank you for undertaking this effort to make affordable, CDFI-issued, small installment loans available to the millions of American families who could benefit from them. We commend the CDFI Fund for defining loan programs eligible for funding as those "repaid in installments." By contrast, single-payment loans have a long track record of failing consumers because their large payments lead to extended reborrowing.

For too long, many Americans have been unable to meet one of their core financial needs via affordable providers—borrowing small sums of cash. This financial exclusion has played a major role in creating a large, high-cost loan market that includes products like payday, auto title, rent-to-own, pawn, and other subprime loans. Consumers spend several hundred billion dollars each decade on fees and interest for these loans,[5] even though all payday loan customers have a checking account,[6] and most other high-cost loan borrowers are also banked.[7]

Pew's research has found that roughly 12 million Americans use payday loans each year,[8] while 2.5 million use auto title loans,[9] 10 million use non-depository traditional installment loans,[10] and millions more use other forms of high-cost small credit including pawn, rent-to-own, and subprime purchase money loans.[11] When banks offered deposit advance—a harmful, single-payment loan with an APR that usually exceeded 200 percent—approximately 15 percent of eligible checking account customers used it.[12] All of these figures suggest not just that there is a demand for small-dollar credit, but that consumers are so motivated to borrow that millions of them accept the very high prices charged by payday and other non-depository lenders. By and large, people who use those products are seeking small amounts of cash to meet a certain need (often, paying a bill) and they typically require several months to pay it off.[13] CDFIs could offer a

[5] Financial Health Network, "2019 Financially Underserved Market Size Study" (2019), https://finhealthnetwork.org/research/2019-financially-underserved-market-size-study/.
[6] The Pew Charitable Trusts, "Payday Lending in America: Policy Solutions" (2013), 4, https://www.pewtrusts.org/en/research-and-analysis/reports/2013/10/29/payday-lending-in-america-policy-solutions.
[7] Federal Deposit Insurance Corporation, "2017 FDIC National Survey of Unbanked and Underbanked Households," https://www.fdic.gov/householdsurvey/.
[8] The Pew Charitable Trusts, "Payday Lending in America: Who Borrows, Where They Borrow, and Why" (2012), 4, https://www.pewtrusts.org/en/research-and-analysis/reports/2012/07/19/who-borrows-where-they-borrow-and-why.
[9] The Pew Charitable Trusts, "Auto Title Loans: Market Practices and Borrowers' Experiences, 1, https://www.pewtrusts.org/en/research-and-analysis/reports/2015/03/auto-title-loans.
[10] The Pew Charitable Trusts, "State Laws Put Installment Loan Borrowers at Risk" (2018), 1, https://www.pewtrusts.org/en/research-and-analysis/reports/2018/10/17/state-laws-put-installment-loan-borrowers-at-risk.
[11] Non-bank credit sources are widely available throughout the country. Payday loan stores exist in two-thirds of states, non-bank installment loan stores operate in 44 states, and both pawn and rent-to-own stores operate in every state. See Question 3 below for more information.
[12] Consumer Financial Protection Bureau, "Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings" (2013), 26, https://www.consumerfinance.gov/data-research/research-reports/white-paper-on-payday-loans-and-deposit-advance-products/.
[13] The fact that payday loans are generally structured as short-term advances due in two weeks belies the fact that most borrowers cannot afford the lump-sum payment and therefore pay a fee to extend the loan another two weeks, and another two weeks, and so on. The payday lender's access to the borrower's checking account enables this cycle.

compelling, more affordable alternative. Payday loan borrowers strongly favor enabling banks and credit unions to offer small installment loans: 95 percent of borrowers believe it would be an improvement to the status quo if regulators enabled "banks and credit unions to offer small loans at prices six times lower than payday lenders."[14]

CDFI banks and credit unions are especially well-positioned to offer small installment loans with affordable payments and fair prices. Their competitive advantages over nonbank providers are large and numerous, as outlined below.

1) They are serving existing customers, or in some cases customers from partner relationships, so they have no customer acquisition costs.
2) They are diversified providers, so they can spread overhead over all their products, unlike specialty lenders, who need to cover all their overhead with just a few products.
3) They have an existing relationship with customers, which minimizes fraud and means customers are motivated to repay.
4) They have the lowest cost of funds.
5) They can underwrite based primarily or exclusively on internal data, such as cash flow, deposit history, and length of relationship.
6) By integrating a small-dollar lending solution with their mobile or online banking and automating the lending process, they can be easier and faster than any nonbank provider.

These competitive advantages are so large that banks and credit unions can profitably issue small loans at a price point six to eight times lower than average payday loan pricing. CDFIs issuing employer-based installment loans also have major competitive advantages over high-cost lenders, enabling them to issue loans profitably at a much lower price than high-cost lenders. The employment relationship provides many of the same advantages that banks and credit unions have, as outlined above.

To date, many CDFIs operate small-loan programs, but relatively few have reached sufficient scale to challenge the dominance of payday and other high-cost lenders. The problem with these programs from a consumer's perspective has not been high costs, unaffordable payments, or the other flaws that characterize high-cost loans; instead it is that the loans are not widely available, not funded quickly, and have a more difficult application process than high-cost loans. For CDFI loans to compete successfully with high-cost loans, the foremost need is for them to scale. Losses on small-dollar loans from CDFIs, banks, and credit unions have been modest. **The primary obstacles to these providers scaling loans have been high operating costs and choosing to charge very low prices that have made them unprofitable. Therefore, Pew recommends that the CDFI Fund allocate the bulk of program funding to**

[14] In Pew's analysis, banks and credit unions could offer small loans with prices six times lower than payday lenders while still being profitable, if loan origination and maintenance were automated. The U.S. Bank Simple Loan product (discussed below) is widely available to borrowers with damaged credit histories and carries pricing at the low end of Pew's forecasted range.

technical assistance for CDFIs to automate the lending process, and little if any to loan loss reserves.

For CDFIs to succeed in the small-loan market, they will need to recognize and adapt to its unique characteristics, including designing credit that works for those in financial distress. Consumers seeking small sums have very low credit scores and poor options. They focus on speed, ease of application, and certainty of approval, rather than the terms that will affect their longer-term financial health—price and affordability.[15] As a result, lenders compete on these factors rather than on price or affordability.[16] With proper assistance from specialty providers with expertise in automated underwriting and origination, CDFIs can compete with payday and other high-cost lenders on speed, ease, and certainty, and use the inherent advantages of diversified mainstream financial institutions to offer affordable payments and substantially lower prices. Supporting the growth of safe small installment loans from depository institutions and other CDFIs would help keep people from turning instead to the lightly regulated, costly, and inefficient high-cost loan sector.

Standards for Safe Small Installment Loans

In 2018, based on years of research, including extensive empirical research and modeling of bank small-dollar loans, and more than 100 conversations with bank and credit union executives, Pew developed standards for safe, small installment loans from banks and credit unions.[17] They are as follows (see figure below):

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[15] The Pew Charitable Trusts, "Standards Needed for Safe Small Installment Loans from Banks, Credit Unions" (2018), 5, https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/02/standards-needed-for-safe-small-installment-loans-from-banks-credit-unions.

[16] The Pew Charitable Trusts, "How State Rate Limits Affect Payday Loan Prices" (2014), https://www.pewtrusts.org/en/research-and-analysis/fact-sheets/2014/04/10/how-state-rate-limits-affect-payday-loan-prices.

[17] The Pew Charitable Trusts, "Standards Needed for Safe Small Installment Loans from Banks, Credit Unions" (2018), 8, https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/02/standards-needed-for-safe-small-installment-loans-from-banks-credit-unions.

Safe, Small Installment Loans Should Meet All of These Criteria

Checklist for new, scalable, consumer-friendly small-dollar credit from banks and credit unions

- ☑ Serves customers who would ordinarily use higher-cost small loans by offering installment loans or lines of credit
- ☑ Payments are no more than 5 percent of paycheck or 6 percent of deposits
- ☑ Annual percentage rates do not exceed double digits, inclusive of all fees, with rates declining as loan sizes increase
- ☑ Total cost is no more than half of principal
- ☑ Costs are spread evenly, other than annual or small application fee
- ☑ Loan payments cannot trigger overdraft or nonsufficient funds fees
- ☑ Reports are sent to credit bureaus
- ☑ Borrowers may take only one loan at a time
- ☑ No more than 1 in 10 of each institution's small installment loans is charged off
- ☑ Loans are available quickly through online and mobile banking

Source: The Pew Charitable Trusts (2018)[18]

We are pleased that the first mass-market affordable small-dollar credit—U.S. Bank's Simple Loan, launched two years ago— met most of these criteria, including setting payments at 5 percent of income and pricing loans in the range Pew had identified as mutually sustainable for banks and customers.[19] U.S. Bank's extensive pilot prior to rolling out the product found that the payments and pricing Pew recommended were viable for the bank and customers. Pew's research has found consumers fare better when the charges they pay are based on the length of the loan (such as a monthly or daily cost), rather than one flat, upfront fee,[20] as U.S. Bank is charging. But the core elements of this first large-scale bank installment loan program are largely sound, and they provide a useful template for CDFI banks to consider.

[18] The Pew Charitable Trusts, "Standards Needed for Safe Small Installment Loans from Banks, Credit Unions" (2018), https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/02/standards-needed-for-safe-small-installment-loans-from-banks-credit-unions.

[19] For more discussion of the U.S. Bank announcement, see Bourke, Nick, "Momentum is Building for Small-Dollar Loans" (Sept. 12, 2018), https://www.pewtrusts.org/en/about/news-room/opinion/2018/09/12/momentum-is-building-for-small-dollar-loans.

[20] The Pew Charitable Trusts, "State Laws Put Installment Loan Borrowers at Risk" (2018), 23-27, https://www.pewtrusts.org/en/research-and-analysis/reports/2018/10/17/state-laws-put-installment-loan-borrowers-at-risk.

Very few consumers can afford to repay loans in just two weeks without borrowing again, so giving them adequate time to repay in installments is crucial.[21] Pew's extensive research on the affordability of small loans has found that borrowers can typically afford to sacrifice about 5 percent of each gross paycheck (or 6 percent of each net paycheck or incoming deposit) toward loan payments. Using a simple payment-to-income ratio like this as a consumer safeguard in addition to automated underwriting is a strong consumer protection that enables access to credit without payments that overwhelm consumers' budgets.[22] Using a payment-to-income ratio appropriately results in shorter terms for smaller loans and longer terms for larger loans. For example, the median monthly incoming deposits for a deposit advance customer were about $3,000—6 percent of that is $180, a reasonable monthly payment size for such a borrower. Payday loan borrowers earn somewhat less, about $2,500 gross monthly income, which would mean a monthly installment payment of about $125. Accordingly, a $500 loan would typically take between three and six months to repay. Though CDFIs may choose to set loan sizes in $100 increments, or particular minimum or maximum loan sizes for these programs, consumers have a variety of credit needs. As an example, pawn loans average about $120, payday loans average $375, and auto title loans average about $1,000. Some high-cost lenders have begun extending loans of more than $2,500. As responsible small installment loan programs mature, regulators should allow the flexibility for consumers to access a variety of loan sizes if banks are willing to provide them.

Providers would be wise to follow U.S. Bank's lead and limit payments to 5 percent of income. Pew's research has found these payments to be affordable for the bulk of struggling consumers. Using a simple payment-to-income ratio avoids the difficulties of trying to determine whether one consumer can afford just 3 or 4 percent of a paycheck while another can truly afford 6 or 7 percent. Using a 5 percent gross (or 6 percent net) payment-to-income ratio is easy to automate, as U.S. Bank has done.

Pew's standards also help establish the balance necessary for responsible small-dollar lending to benefit both customers and providers. If providers set payments that are too large, as with payday loans and deposit advance, customers will suffer. But if providers are unable to serve customers with a high debt-to-income ratio or low credit score, this type of lending will not help the bulk of those who use high-cost loans today. If APRs inclusive of fees are required to be below 36 percent, programs have usually not been profitable or have not reached customers who need help.[23] But APRs higher than 100 percent are unnecessary for bank or CDFI small-dollar loans to be profitable, and excessive pricing can harm customers' financial health. As an example, to borrow $400 from a payday lender for 3 months today costs about $360 on average. But banks can make that loan profitably for about $60 with sufficient automation.

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[21] The Pew Charitable Trusts, "Payday Lending in America: How Borrowers Choose and Repay Payday Loans" (2013), 13-15, https://www.pewtrusts.org/en/research-and-analysis/reports/2013/02/19/how-borrowers-choose-and-repay-payday-loans.

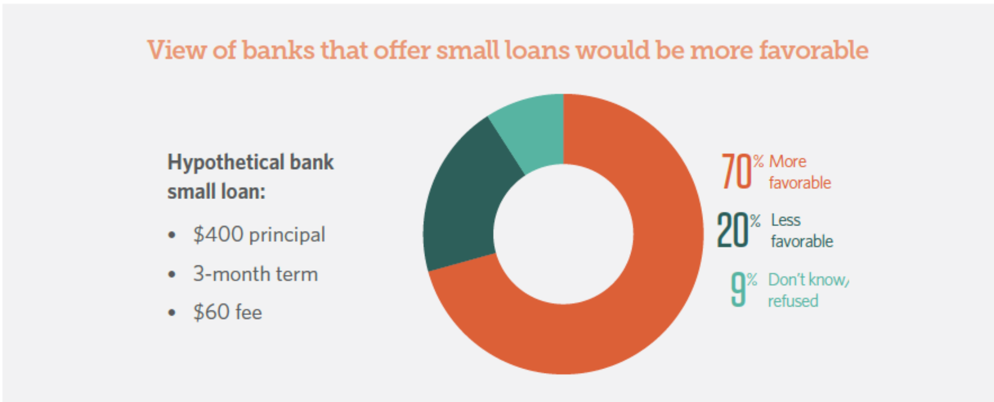
[22] The Pew Charitable Trusts, Oct.7, 2016, comment letter to Director Richard Cordray regarding "Proposed Rule for Payday, Vehicle Title, and Certain High-Cost Loans, Docket ID: CFPB-2016-0025," 44-53, https://www.regulations.gov/document?D=CFPB-2016-0025-142716.

[23] The Pew Charitable Trusts, comment letter on the NCUA's Notice of Proposed Rulemaking on the Payday Alternative Loan Program RIN 3133-AE84 (August 3, 2018), 6-8, https://www.ncua.gov/files/comment-letters/2018/comment-pal-20180803NBourke.pdf.

CDFIs using similar automation are likely to be able to lend at that price or slightly lower. Such loans would save hundreds of dollars for consumers, even though the APRs would tend to be higher than those for credit cards. The public views such loans favorably, as shown below.

70% of Americans Would View a Bank More Favorably if It Offered Lower-Cost Small Loans

Percentage of respondents



Notes: Respondents were asked: "Some banks are considering offering a $400, three-month loan with a $60 fee. Payday lenders charge about $350 for the same loan, while using a credit card would usually cost less than $60. If a bank began offering a $400, three-month loan for a $60 fee, would your view of that bank be more favorable or less favorable?" Results are based on 1,205 interviews. Numbers do not total 100 percent due to rounding.

Source: The Pew Charitable Trusts (2017)[24]

Automation is the Key to Success for Providers and Consumers

The high operational costs of manually processing loan applications, underwriting loans, issuing them, and servicing them would lead CDFIs to charge very high prices, lose money, or only manage very small programs. To avoid these fates, CDFIs will need to automate the lending process. A small number of CDFIs may choose to build platforms in house, though that process has been costly and time-consuming for other providers, so it will be impractical for most. Another option is to use third-party service providers to automate the entire process. These partnerships can help CDFIs offer small loans in a largely automated fashion without requiring a hefty upfront investment or substantial staff time. Service providers' offering a white-labeled interface available through mobile or online banking or an employer-based platform is likely to substantially improve the ability of most CDFIs to offer small installment loans. This type of third-party relationship, as long as it is carefully monitored to ensure compliance with its standards and regulatory requirements, is likely to benefit consumers by making CDFI-issued, affordable loans available to them.

[24] The Pew Charitable Trusts, "Americans Want Payday Loan Reform, Support Lower-Cost Bank Loans" (2017), https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/americans-want-payday-loan-reform-support-lower-cost-bank-loans.

We recommend the CDFI Fund be very selective when making grants to programs that manually process each loan application or involve staff time to underwrite and originate each loan, because such programs are unlikely to scale. While they can be helpful in specific circumstances, such programs have a history of not producing enough volume to meet general consumer need. Manual processes may work for larger loans or for ad hoc small-loan programs, but in general they are both too costly for providers and too cumbersome for customers who today turn to payday and other high-cost lenders.

When consumers are in financial distress and seek to borrow small sums, they focus primarily on three factors: certainty of approval, ease of obtaining funds, and how quickly they can receive the loan proceeds. Payday and other high-cost lenders know this and compete accordingly. Therefore, speed, ease, and certainty must be paramount for CDFIs to compete successfully. If CDFIs do not offer loans as quickly and simply as payday lenders, or consumers do not believe they will qualify for small loans from CDFIs, consumers will continue to borrow elsewhere.

Many CDFIs can outcompete with payday lenders on speed, ease, and certainty using automation. As an example, U.S. Bank makes small loans available exclusively through mobile and online banking, makes applying quick and easy, and deposits loan funds faster than nonbank lenders. Therefore, consumers have been choosing these loans. Though consumers focus on speed, ease, and certainty, the affordability of payments and the cost of loans are what affect their financial health. In short, for responsible small installment loans to improve consumers' well-being, they must check the three boxes consumers most care about when they are in financial distress—speed, ease, and certainty—as well as meet the two criteria that improve their financial health—affordable payments and reasonable prices.

A secondary factor that could discourage consumers from borrowing from CDFIs would be if they could lose their checking account in the event of loan default. The CDFI Fund should ensure that if CDFI depository institutions offer small loans, consumers should not lose access to their checking or other accounts if they default on small-dollar loans, just as defaulting on an auto loan would not cause them to lose their checking account.

Automation is probably the single most important factor to ensuring the success of a small-loan program. Another key factor is pricing loans to allow for the mutual success of CDFIs and customers. If loan prices carry three-digit APRs, that can hurt consumers' finances because prices are too high, and providers may suffer reputational harm. If prices are too low because providers focus on showing an APR below 36 percent for small loans, programs usually have either not served customers who have low credit scores and need help, or programs have not been profitable, so providers have been reluctant to scale them. There have been viable programs with APRs below 36 percent, such as employer-based installment loans, but they are the exception.

Providers having access to the borrower's checking account and deposit stream is often an important element of risk management for many providers that operates this kind of small-loan program. The power to deduct required loan payments from an account that receives regular deposits is what enables lenders to offer loans to consumers with damaged credit histories, who, by definition, present a higher risk of default than mainstream borrowers. This is true of payday lenders (who hold post-dated checks or establish ACH withdrawals timed to the borrower's payday), banks, credit unions, and CDFIs. Depository institutions have been more likely to make small installment loans available, and at relatively low cost, when they have automated payments against the borrower's deposit stream.[25] In exchange for this power, however, strong safeguards are appropriate, such as limiting each payment to 5 percent of the borrower's gross income or 6 percent of the borrower's net deposits during the period.[26] Nonbank lenders have demonstrated it is possible to withdraw payments far larger than customers can afford when they have access to borrowers' checking accounts on payday. To avoid such abuses of this access, safeguards around affordability and ensuring payments do not trigger overdrafts are necessary.[27]

With the possible exception of the smallest loans offered as a customer acquisition strategy, under a new, large-scale small-loan program, CDFIs are likely to cover their lending costs only when they offer this credit via an online or mobile platform to people with whom they have an existing relationship. Such channels will enable CDFIs to compete on speed, ease of access, and certainty of approval, while also minimizing staff time and processing costs. We are aware of five to six service providers that offer turnkey small-loan programs that can be integrated with providers' online and mobile platforms. These specialty companies base eligibility for small credit on consumers' checking account history and other criteria. Whenever possible, small loans should be advertised only to consumers who have a high likelihood of approval to reduce uncertainty about whether they can qualify for these loans. By setting eligibility criteria for pre-screening, such as a certain length of time with their current checking account, having direct deposit, or the account being in good standing, providers can minimize processing applications that are likely to be declined, which discourages consumers from applying for CDFI loans and incurs costs for the CDFI.

Traditional credit reports and scores are of limited use in differentiating between likelihood of repayment among customers with damaged or limited credit histories.[28] Most consumers who use small-dollar loans have low credit scores. Because of the cost of pulling a credit report for a small institution and its limited predictive value for these loan programs, we strongly recommend that doing so not be required as part of determining eligibility for a small-dollar loan. Automated underwriting conducted by a service provider that includes length of account

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[25] This suggestion would comply with the Electronic Fund Transfer Act. Our recommendation is that CDFIs encourage customers to use automated payments to maximize the chances that customers repay successfully.

[26] Pew has previously discussed how allowing deposit account access in exchange for certain strong customer safeguards is the simplest and most powerful risk management and consumer protection tool available in small-loan programs. See e.g. The Pew Charitable Trusts, Oct.7, 2016, comment letter to Director Richard Cordray regarding "Proposed Rule for Payday, Vehicle Title, and Certain High-Cost Loans, Docket ID: CFPB-2016-0025," 44-53, https://www.regulations.gov/document?D=CFPB-2016-0025-142716

[27] The Pew Charitable Trusts, "Fraud and Abuse Online: Harmful Practices in Internet Payday Lending" (2014), https://www.pewtrusts.org/en/research-and-analysis/reports/2014/10/fraud-and-abuse-online-harmful-practices-in-internet-payday-lending.

[28] Sumit Agarwal, Paige M. Skiba, and Jeremy Tobacman, "Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles" (2009) https://www.nber.org/papers/w14659. The authors find that specialty data are much more predictive of payday loan repayment than FICO score.

history and presence of direct deposit among other factors is likely to be a stronger predictor of repayment.

Technology can be leveraged to ensure that borrowers can easily apply, are encouraged to opt in to automatic repayment, and are suggested the most appropriate credit product that meets their needs at the lowest cost. Many borrowers cite the ease of application as a reason why they use conventional payday loans, and CDFIs will need to offer interfaces that provide the same or better levels of service to be competitive. Mobile and online platforms can reduce the friction of application while enhancing customers' experiences.

Borrowers will be more successful repaying small installment loans if they use automatic repayment, thus preventing an unintentional missed or late payment that would show up on their credit report or lead them to lose eligibility to borrow. Incentives to choose auto-repayment, such as a small price reduction, can boost the probability that the borrowers will use automatic payments and succeed in repaying on time.

Recommendations

We recommend that the CDFI Fund give priority to programs that demonstrate long-term financial sustainability and have a path to scale. For this reason, we recommend the bulk of funding, if not all funding, go to technical assistance for automating small-dollar lending rather than to loan-loss reserves.

The primary problem with small-loan programs from lower-cost providers is that they have not expanded sufficiently to serve the tens of millions of Americans who use high-cost credit. Automation and charging necessary prices to at least cover their costs are the two keys to scale. Pew has developed standards for how to offer mutually beneficial loans in a scalable and sustainable way, including setting installment payments at 5 percent of gross income or 6 percent of net income.

Small-loan programs from low-cost providers like CDFIs have generally had manageable losses, so it is not likely that simply adding funds to cover small losses would lead to the needed long-term scale, sustainability, and impact.

Thank you for your consideration, and we are glad to discuss our research and these recommendations for expanding affordable small installment loans.

Sincerely,

Nick Bourke
Director, consumer and home financing